Making Taxes and Welfare Work Together (panelist)

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Speech

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THE ROLE OF GOVERNMENT

One of the central functions of modern governments is to redistribute income from those who are rewarded by free markets to those who are not. Before taxes and transfers, the top 20 percent of U.S. households get 20 or 30 times as much income as the bottom 20 percent—and top households have hundreds of times as much wealth. The current tax and transfer system reduces income inequality by about 20 percent and cuts poverty in half.

But we can do better. The key is to adopt policies that encourage work and the development of work skills.

INCREASE THE ECONOMIC REWARDS FOR LOW-SKILLED WORKERS

First, government policies should increase the economic rewards for low-skilled workers. That would make work more attractive than welfare, and it would make honest work more attractive than the wages of crime. Pertinent here, the United States has the highest incarceration rate in the world—486 adults per 100,000 in 2004. And the number of people behind bars has increased from ½ million in 1980 to more than 2.1 million today. Almost 90 percent of those in prison or jail are men, and almost 56 percent of those men are under the age of 35.

KEEP EFFECTIVE TAX RATES ON EARNED INCOME LOW

Second, we should keep the cumulative tax rates on earned income as low as possible.

In order to have low tax rates, a tax system must have a broad base. Unfortunately, the current system has tax breaks for everything from oil wells to chicken farms. Since Stanley
Surrey was the Assistant Secretary of Treasury in the 1960s, we have known that the more of these “tax expenditures” that we can get rid of, the lower tax rates can be.

Also, we need to keep the benefit-reduction rates in the welfare system as low as possible. Here, since Milton Friedman and others first proposed a “negative income tax” in the 1960s, we have known that a comprehensive system would work much better than the current jumble of overlapping and conflicting welfare programs.

A COMPREHENSIVE TAX AND TRANSFER SYSTEM

MAKING TAXES WORK
First, we should reform the tax system. Many of the problems of the current system are the result of having two major taxes imposed on earned income—income taxes and Social Security taxes—and then using the earned income tax credit to refund those taxes to low-income workers.

I won’t bore you with the details, but the combination of income taxes, Social Security taxes, and the phase out of the earned income credit often results in extraordinarily high tax rates on earned income, and the highest rates are imposed on single parents earning around $30,000 a year.

If it were up to me, I would combine the income and Social Security taxes into a comprehensive income tax system—with a broad base and low rates.

MAKING WELFARE WORK
Second, we should reform the welfare system. Right now, something like 85 separate federal programs provide income-tested welfare benefits. To keep costs manageable, virtually all of these programs phase benefits out as family income increases. Unfortunately, these phase-outs
combine with income and Social Security taxes to impose confiscatory tax rates on many
recipients.

According to a recent study by Gene and his colleague, Adam Carasso, families earning
between $10,000 and $40,000 a year face an average tax rate of 36 percent. When the phase-outs
of food stamps, Medicaid, Temporary Assistance for Needy Families, housing, and child care
subsidies are taken into account, the average rate jumps to 88 percent.

The current welfare system also has financial penalties that can discourage marriage.

I believe that we should replace most of the current welfare system with a system of
refundable tax credits. The general idea is to “cash out” as many welfare programs as possible
and use that money to help pay for refundable tax credits.

**MAKING TAXES AND WELFARE WORK TOGETHER**

In short, we should replace the current tax system and most of the current welfare system
with a comprehensive tax and transfer system. That system could have just two tax rates—say,
20 percent on the first $50,000 of income and 35 percent on income over $50,000—and it should
have a few refundable tax credits.

First, we should replace personal exemptions, standard deductions, child tax credits, and
most of the current welfare system with a universal, $2,000-per-person refundable tax credit.
Under this approach, a single parent with two children would receive $6,000 a year in personal
tax credits, and a married couple with two children would receive $8,000 a year.

Second, we should replace the current, family-based earned income tax credit with a
$2,000 or $3,000 per worker credit. For example, a $2,000 per worker credit could be computed
as 20 percent of the first $10,000 of earned income.
The current earned income credit provides up to $4,500 a year for families but just $400 a year for childless workers. On the other hand, a $2,000 or $3,000 per worker credit would help all workers, and it would eliminate most marriage penalties.

Third, we should make the child and dependent care credit refundable—and expand it so that it reimburses low-income workers for up to 80 percent of their child care expenses. Child care can easily cost $100 a week per child, but government agencies provide child care assistance to less than 15 percent of low-income families, and the current dependent care credit provides almost no help.

Fourth, we should replace the current exclusion for employer-provided health care coverage with a refundable health care tax credit. The current exclusion costs the Treasury more than $100 billion a year, but it is poorly targeted. Some 46 million Americans lack health care, and most of them are working. We should cap the current health care exclusion and gradually replace it with a refundable tax credit.

Of course, these refundable tax credits should be paid out on a monthly basis. Each individual would present something like the current IRS Form W-4, Employee’s Withholding Allowance Certificate, to her employer—or to a bank. Employees would then receive advance payment of their credits from their employers in the form of reduced withholding, while other beneficiaries would have their payments directly deposited into their bank accounts.

**Discussion**

This new, comprehensive tax and transfer system would be simpler than the current system.

It would encourage low-skilled workers to enter and remain in the workforce.
It would minimize marriage penalties.

And it would help ensure that low-income families actually get their benefits. TANF currently reaches just 52 percent of eligible families, and food stamps reaches just 62 percent. On the other hand, the earned income tax credit reaches 86 percent of eligible households, and it does so without any welfare stigma or loss of privacy.

As an initial step, we should cash out food stamps. Like most welfare programs, the Food Stamp Program has arcane eligibility criteria and baffling administrative procedures, and the program has high administrative costs. We should repeal the Food Stamp Program and use its $30 billion-a-year appropriation to help pay for refundable tax credits.

Next, we should cash out low-income housing programs. Instead of providing a small fraction of low-income families with rental subsidies or mortgage-interest subsidies, we should give all low-income families $2,000 per person tax credits and let them choose their own housing.

The bottom line is that we are unlikely to achieve any meaningful improvement in the welfare system by simply, in Edgar K. Browning’s words, “trying to patch up each one of the innumerable and uncountable programs.” Instead, we should replace the current system with a comprehensive tax and transfer system—with large personal tax credits, large worker credits, and low tax rates on earned income.